Welcome to the Vandenack Weaver legal visionary’s podcast. With your host Mary Vandenack

Welcome to today's episode of Vandenack Weaver, legal visionaries, a weekly podcast discussing updated legal news of all being methods of providing legal service and law practice issues. My name is Mary Vandenack founder and managing partner at Vandenack Weaver, LLC. I'll be your host. As we talk to experts from around the country about closely held business tax, trust estates, legal technology, law firm, leadership, and wellbeing for lawyers on today's episode, I am joined by Mike Weaver. Mike Weaver is one of my partners at Vandenack Weaver. He runs our business department, does a lot of business, exit strategies and planning with business owners. And so, we are doing a series of podcasts on business, exit planning. It's been a hot topic in the last few years. We're seeing a lot of money get thrown at business owners and those business owners who weren't necessarily planning on exiting or making decisions to exit. And in discussing that with business owners, that has us aware of the fact that we need to do a little advanced planning. So, I have a business owner I spoke with earlier this week, who said, when do I need to start thinking about business, exit planning? And so, what's the answer to that, when should somebody start thinking about that?

Well, the answer from the lawyer's perspective, as you can never start thinking about it too soon. So, and at any time really is anytime we're, when you're even contemplating the sale of the business or what life is going to be like for you after the business. That's when you need to just start thinking through these various matters that we're going to discuss.

There's a lot that goes into figuring out how to have a business owner come out of the business in terms of, “Hey, what are you going to do next?” Which is really the legacy planning, which we're going to do in another episode. But the other thing is positioning your business so that it is the most sellable. So, we're, that's what we're going to focus on today is what are the tax efficiencies? What should we think about in terms of structure? Should you dig out? Are there any skeletons you need to dig out of your closet? So, if we kind of look at the initial area of a business, some businesses might have multiple different businesses. For example, I recently worked with a company who was in cloud space technology and they were in cryptocurrency space and they were like almost unrelated lines of business. How does that play into an analysis when you start talking to a business owner about, I'm thinking about selling my business, I have these different lines of businesses. How do I package this?

Yeah. Particularly in today's environment where you've got some, maybe serial entrepreneurs that might have a variety of different businesses that they're building, and they may be all housed under one roof. They may have one entity that they're operating their businesses out of. So really what the business owner wants to do is sit down and analyze the different lines that they may have. And it may be a cryptocurrency. It may be a rental business and may be all sorts of different things, or it could be a series of different business types that are all related to one main business. But you need to just sort of look at the businesses to separate lines and say, what is going to be attractive to a purchaser of this? Are they going to one, all these different lines? Is there something that they're not going to want, or is there something that you as the owner might want to keep? So you might want to think about separating those out into separate entities and making and packaging them, them that way so that the potential buyer can sort of take what he wants and you take, keep what you want. And everybody goes down the road so you

Can sell some or all the business depending on what a buyer might want. So, what do you need to think about in terms of equity structure? Obviously, if a business owner is the sole and only owner of the business, that's not such a tough issue, but what if they've sold chairs to employees or they brought in investors to help them get started? And so, they have other owners, what do you need to look at there?

Well, you're right. If it's a simple structure where you've got the owner and it's the sole owner and they own all the shares, that's a pretty easy thing to address. But a lot of times, particularly in some of the, in some of the larger, closely held businesses, you'll have employees or consultants, even that will have pieces of equity in the entity. It may not be direct stock ownership, but it may be Phantom stock. It may be options to acquire stock. And all those things may be triggered on a sale, or they may have implications to the sale. So, the purchaser coming in may not want to deal with all that stuff, because those are, sometimes those are very complicated formulas and they don't want to deal with it and they just want the owner to deal with it.

So it's not a bad idea to look at all those, if you have those types of things, type types of owners, other than just the actual equity owner and decide whether or not before the transaction, should we clean all that up, make it a nice clean deal for the purchaser so they can come in. They know they're dealing with one shareholder or one group of shareholders, and they don't have a bunch of options that they have to consider or other equity interests. So, it's, it's good to just sort of look at your equity structure, who the owners are and, and, and clean it up to the extent you, you think necessary.

And sometimes it's a challenge to get those owners out, which we'll leave for a topic for another podcast, because that's a whole discussion in and of itself. But at the end of the day, what you're saying, and especially what we're seeing right now in the current market is a lot of venture capital getting thrown at businesses, or we're seeing companies buy businesses that wouldn't typically have been in their line trying expand and diversify, things like that. So that's, that's something that's more attractive to those buyers is to come in and have that stock cleaned up, not be dealing with some shareholders that they don't really want to deal with. Another thing that we see, it's not uncommon, especially when we're doing closely held business planning in the early stages and closely held does necessarily mean small business. We have closely held businesses that are just operated by their owners that are international companies, right? So, in those sometimes for a variety of reasons, we may have voting and non-voting type of structures. Is that something that ought to be looked at prior to a transaction? Yeah.

Like what we just talked about. If you have voting and non-voting shares, you may have a preferred class of stock or in a limited liability company, you may have class a, B, C, and D, and they all may have different rights and abilities. And again, the I, what to which want to look at as the business owner is, do I need to clean that up, to make the sale more attractive to a potential purchaser? So if there's preferred stock, that's going to get, that maybe has some dividends that haven't been paid yet clean all that up, maybe cash those people out, make a deal with them before, before the, before the potential purchaser comes in. So that all of that is cleaned up again, like you said, there's a, there's a, there's a certain degree of hotness right now to these types of transactions. And if you want to sell your business, you're probably going to have competition. So, you want to make your business as appealing as possible. And one of the things that you do want to do is just take a look at your, your, your voting classes and the different equity interests that are out there and figure out, is there a way that I can make it really simple to do a transaction with somebody

It's negative asks a lot about financial statements and in talking to you often refer to the term gap. And I don't think a lot of people know what a gap financial statement is some do, but can you describe that for those who don't, what is gap mean?

Well, gap is, well, let me back up first, one of the, one of the first things that you're probably going to get asked to present when you're, when you're talking to a potential buyer is some financial information. That's one of the first things that you're going to be asked for. And, financial information can take a variety of forms depending upon whether you're your wife or your niece, or your daughter has been been, been preparing your books and records over the past number of years, or whether you've got an accounting firm doing it gap just means generally accepted accounting principles. And I shouldn't say just, it is a standard that must be met by a qualified accountant or an accounting firm where they are basically certifying that these financial statements have been prepared in accordance with that standard. And that's a, that's a standard that's used. That's the high standard that's used when for a public transaction, for example, that's, what's going to be used. Your financial statements must be prepared according to gap when you're dealing with closely held businesses. That's not always the case because gap certification is time consuming and not inexpensive. So, a lot of, a lot of closely held businesses might not have their financial statements up to that standard. So

Let's say I own a skating rink and I've decided to sell it. And my ex-husband who was a construction guy is keeping the books actually let's make him something that knows nothing about numbers. Let's say he's an artist, he's a starving artist and he's been doing my books. So, what might I most need to do with those financial statements? I'm betting, I don't have gap statements.

You I'm betting, you don't have gap statements. And just because you go to an accounting firm, doesn't mean that you must get gap statements. You can, you can go to an accounting firm and just say, Hey, I want my, I want you to take a look at my books and clean them up and make sure that they're accurate. And they will, there's a variety of different levels of that review, so to speak that they can provide or that they can do for you. So, but the first thing you're probably going to want to do is probably go talk to some accountant and say here's what I've been doing for the past five years, go through these and clean them up and make sure that they're, they're a good representation of the company. And

What if I've been paying five kids or my nieces and nephews or something like that out of the business, but they're actually often college is that some, I should get it cleaned up off my financial statements before I present them. Yeah.

it's not uncommon for closely held business owners to run certain things through the business. That may be a potential buyer. Wouldn't be a nurse and having run through the business. So, if you, if you have been doing things like that one year, you're not presenting an actual picture of what your financials truly are. Because when the business or when the purchaser comes in, they're not going to want to continue paying, for example, your, your niece or nephew, or whoever's off in college. They're not going to be interested in doing that. So, they want it, they want to take care of those things as the, as the financial information is being prepared to address those things. So that again, when you give those financial and give that financial information to the potential purchaser, they're getting an accurate picture of, of what you've been doing for the past number of years.

And maybe a better example. I mean, we do see some of that type of stuff go on. But what often happens with the business owner is they're trying to build the business. And so, they're keeping cash in the business for growth opportunities and they might be underpaying themselves. And so, we look at a bit as one of the valuation standards, there's some variation of that. And so there would be adjustments to that number in terms of the valuation. But if you're starting out three to five years in advanced, you might want to start cleaning some of that stuff up, or at least be clear what your adjustments would be in terms of evaluation.

Right? I mean, one of the, one of the most common things is just what you said, or you've got, you've got an owner who otherwise would have, if they weren't there, they would be, they would have to be pending a manager or a CEO or someone, a salary in order to do what they're doing. And they're often underpaying themselves. So, you do have to make an adjustment for that, for the potential buyer that's coming in to get a realistic view of what your revenue is. And on the other hand, it can be, you may have been overpaying yourself because you've, you've come to the, your end of the cycle in the business. You're, you're getting ready to retire. You're paying yourself a little more every year. So, there might be an adjustment downward on that to get to an accurate picture of what the financial is really. So that could be either way, and you may

Be running some travel expenses through the company that say they're totally legitimate travel expenses, but another company taken over might not have the same travel policy is things like that. So, there's essentially two ways that businesses get purchased. Can you explain what those two purchase types are? And what I would really like to hear from you is what should be considered? This is always something I think is so important that a client think about the different forms of purchase before they agree to a price, because there's huge differences in the tax allocations and the actual value of the business based on the type of purchase. So, a client comes to and says, Hey, I just sold my business for $10 million and you're like stock sale or asset purchase. Right. Right. Why do we care?

Well, how much time do we have? So, Okay. The bullet point version today, and we'll do another podcast to discuss it in detail.

Overall, there's two, two types of, of transactions. And you mentioned them both. Then there's an equity transaction. So, for example, if you're a corporate, you're buying a corporation, you will be purchasing the stock. If you're buying the, if it's a limited liability company, you're buying units in the limited liability company, if it's a partnership you're buying partnership interest. So that's the equity transaction. So, you're buying the interest of the entity. The other type of transaction is an asset acquisition. So, for example, I've got a corporation that owns a hundred trucks instead of buying the stock of the corporation. I just want to buy the trucks. So, I just buy the assets out of that company. I just pay the company X dollars for the trucks. That's an asset acquisition, and they are two very different types of transactions. When I think the most important difference or one of the most important differences is when you're, when you're purchasing the equity of an entity. So, a corporation, for example, you are basically stepping into the shoes of that prior owner owner. So, whatever, whatever assets it has, whatever liabilities it has, you're basically stepping into the shoes of that owner.

Let's say they get for, just have this happen with a client. They sold stock. And now there's an audit for prior years. And I assume you cover that type stuff in agreement, but if you didn't, that'd be year of potential liability, correct?

Correct. If I had just came in and I paid you X dollars for that, for that stock. And then the IRS comes in and from two years ago, and I didn't own it, they do an audit and they say the company's liable for X amount of tax. I, as the new owner, I'm responsible for paying that tax, or, I mean, as the owner of the company, the company is paying the tax, but essentially, it's coming out of my pocket. So yeah, in that, that's, that's a typical liability that can arise when you're buying the stock. And there may be a breach of contract claim for some supplier that you were dealing with. All those potential liabilities, you as the new owner, you're basically assuming those by buying the stock. Now, like you said, in the purchase agreement and the, in the, in the, in the stock purchase agreement, you will normally try and address all those things. If there is an unexpected tax audit who is responsible for that, if there is a lawsuit related to something that happened before I bought the business, who's responsible for that. So you're usually gonna try and cover that, but you do need to make sure that you do, because if you just go in and buy the stock and you haven't addressed those things, you could be on the hook for a lot of stuff.

And in the current market, a lot of times you do see the desire to purchase stock and that's sometimes your venture. I mean, there will be all kinds of structures that we do. It can be both ways, but what we've seen this last year is a lot of venture capital companies buying stock. And so, with that said, when you're doing that type of purchase, we refer to what we call skeletons in the closet, and you should get those skeletons out of your closet well in advance. So, what kind of things might fit that term of these are the skeletons in your closet, that before you put this up for sale, you're going to want to clean up,

Well, we kind of talked, we talked about a few of them already, and that is if you've got certain expenses that mayor may or may not be questionable, that you're running through the company, you want to take a look at those and make sure that they're cleaned up because again, it's going to affect the financials, but it's also gonna affect the purchaser's willingness to continue with the deal. There's always the buyers, or it's always the seller's desire to present the picture of the company in as best delight as they can. And that's understandable. They're trying to get the highest price that they can, but you do have to do that, knowing that the, the, the pure the potential purchaser is going to come in and they're going to do their due diligence. They're going to ask you for all sorts of books and records, not just financial, but about your contracts, about your employees, about your pension or your profit-sharing plan. All those things they're going to ask about. So, you to be proactive as a business owner are going to want to go through basically that due diligence and say, okay, what, what could pop up here that could derail this transaction,

Do your own due diligence in advance of the transaction? The reality is that that due diligence might be slightly different in an asset sale or a stock sale, but there's due diligence in both. And your agreements covering the transactions are different, have different reps and warranties like you and I recently ran into kind of a combined asset equity purchase. And that was the big concern you raised was, well, how does this work in terms of reps and warranties when you have a dual transaction, but that cleanup applies.

Yeah, it really does. Particularly even if it's an asset deal, they're going to want to know that the assets that they're buying are that they're getting free and clear of all liens and governances and other claims. So, you're going to want to do a similar type of due diligence, no matter what transaction you're doing.

The other thing that we talk about when a business owner is getting ready to sell is they have to give some thought to life after the sale, including things like, are they going to retire or are they going to continue to work? Was this just again, we've mentioned we have serial entrepreneurs to business after business, they just buy a business, create a business, build a business, sell it. That's what they do. It's fun. Right. And so what kind of things do they need to consider in terms of, let's say it's one of our serial entrepreneurs and they're planning on going and doing another business of some sort before they sell this business, what do they need to think about?

Well, the most important thing is that they think about it because I just talked to a client the other day where he's at the age where most people are ready to retire. And his statement to me was if I sell this, what am I going to do? And that's my question to him was, yeah, what are you going to do? So, they need to think about that. But a lot of times what may happen is when the purchaser comes in, particularly if it's if the, if there's one significant owner and there really important to the operation of that business, the purchaser may want them to continue on for some period of time, so that you may want to have an employment agreement or a consulting agreement as part of the deal where you agree to stay at you as the business owner, agree to stay on for a year or two years. And that keeps you involved in the business, but probably to a lesser degree, depending on what the purchaser really wants and what you want. And I want you to negotiate. I mean, you may limit it to five hours a week, and it may be 30 hours a week, depending on how involved do you want to be in the business afterward?

What if you want to start a competing business?

Well, typically when, when a purchaser comes in and they're buying your business they're gonna want you to agree, not to compete and not to solicit. And those are two different things. One, and they're often in the same agreement, but to not compete, meaning I'm not going to go across the street, set up a business and then try and steal all my former customers from you. So those are those that is an agreement that a purchaser is usually going to want. And you're going to have to probably negotiate that. And the things that you're going to want to negotiate is the time, how long can I not compete? And how long can I not solicit, particularly if you're a serial entrepreneur and who knows what you're going to to do in the next three or four years how long, and then the geography of the thing, and what states am I just limited to say, Nebraska? I can't compete in Nebraska.

Okay. I can go across the river and go set it up in Iowa. What region am I prevented from competing in and soliciting him, and largely, that's going to be driven by what region you're in, when you're doing your business before you sell it.

So, whether it's a local, regional, international, and national business to be a little bit tougher, right. Mix. So, some clients want to figure out how to have their business continue to pay them, essentially the equivalent of, I call it an annuity after they leave. Can you do that? Can that be beneficial? Is there a way to, is that will sellers consider that type of options are there?

They can and again, the employment agreement is a way to do that another, there, there are a couple of different things, and it does kind of depend on the type of business that you have, but a lot of, a lot of operations will have the real estate owned by a separate entity and the actual operations of the company or the operating entity will then lease the real estate from that, that other entity, well, after post to sale the purchaser for whatever reason might not be interested in knowing in the real estate. So, the, the, the selling party can retain ownership of the real estate, continue to lease it to the new owner and get an income stream off that. And that's appealing to potential potential sellers, because again, they've been working this business for their entire lives, and now they're selling it's not just what do I do, but it's also, where's my income going to come from. Yeah, I got it. I might get a chunk of cash, but I would like to have some other income streams still coming in. So rental is a good way to do that. You continue to rent the business or you continue to rent the real estate to the new owner. That's, that's a common thing that can happen. Another thing is you may have a business that has a lot of intellectual properties surrounding it.

I mean, example, would that be like, let's say I'm a mad scientist and I come up with a formula that women can just dab on their face and make all of their wrinkles go away and make them look like they're 20 forever. Right. Would that be in the intellectual property category?

Hopefully you've patented that procedure. So, a patent that would be an example of intellectual property rights.

And it can also be your name. Let's say you attached Mary Vandenack to that product. That's a particularly good one for wanting to preserve some rights in it, because you might not want to sell that to Mike Weaver because you don't know what Mike was going to do to your good name after he sells it. So, you may want --

To read it. And she was a terrible tax lawyer or something.

I wouldn't say that, but somebody might resell it when I resell it. That's right. So, you may, you as the owner of that intellectual property, be it a name or some other patentable thing, you may want to retain the rights to that. So, you could drop that into another entity, sell the business, and then license that IP to the entity so that you do retain some control over the IP. And then again, that's another income stream through that licensing.

Well, thanks, Mike. I think we've covered some presale considerations in detail today, so we'll stop there for now, but we are going to continue to talk about business, exit planning in a series of podcasts. Thanks for listening today's episode and stay tuned for our weekly releases,

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